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IRELAND AND EUROPE'S NEW MONEY

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Ireland and Europe's New Money

In 1990, the ESRI honoured me with an invitation to deliver the annual Geary Lecture honouring the memory of Dr Robert Charles Geary, the eminent statistician and social scientist and the first director of the Institute. I do not know whether I lived up to the expectations of my hosts, but I do know that their warm and generous hospitality, and the vivid interest in ideas and debate more than did justice to Ireland's fame as a wonderful country.

Before entering the discussion of European money, how to get there and what it might do to North-Atlantic monetary relations I wish to spend a moment, by way of repentance, on my misreading of Ireland's economic prospects in 1988-89. Ireland's case serves well to introduce the topic of convergence because of the dramatic progress achieved in the past few years.

A few years ago, when Ireland's prospects did not seem fortunate at all, I expressed the opinion that Ireland's stabilization had failed.[1] It is difficult to believe a less auspicious time to make that forecast. No sooner had the galleys gone to press, then did the 'Irish miracle' develop: successful incomes policy, less-than-German inflation, major and sustained budget correction, strong growth, and a falling debt ratio. The perspective of 1985-88 was a singularly unfortunate time to assess what Ireland would look like only a few years down the road.

Of course, it would be a mistake to declare the battle won. The debt ratio remains high, growth is strongly dependent on

1. The essay in question was written in the summer of 1988, see Dornbusch (1989). My discussant on that occasion, Patrick Honohan was of course right in emphasizing that I did not put any weight on the important changes that has been accomplished already. The *Medium-Term Review* of the ESRI read well the change in writing in June 1989: 'We project a pattern of sustained growth for the next five year period, 1989-94. The average annual growth rate should be in the region of 5 per cent, with higher growth in 1990 and 1991 followed by a slowdown in later years.'

Table 1: *Ireland's Successful Stabilization*

	1985-87	*1988-90*	*1991*[a]
Growth	1.7	4.0	2.2
Inflation	4.2	3.2	3.0
Debt[b]	130.7	125.4	113.4
Primary Budget	- 3.3	3.9	4.5
Unemployment	17.4	15.7	14.7

[a]Forecast, [b]Per cent of GDP.
Source: OECD.

external demand, real interest rates stay high, so will Ireland's which would mean continued pressure for primary surpluses to stop debt from rising (see Figure A). These concerns are justified but, no doubt, at this time all indicators point in the direction of continued improvement.

The improvement in the financial outlook is clearly apparent from the Ireland-Germany interest differential (see Figure B). The differential has narrowed to less than two per cent. The Irish currency is becoming almost as hard as the DM. This pro-

Figure A: IRELAND: REAL INTEREST RATE
(Percent)

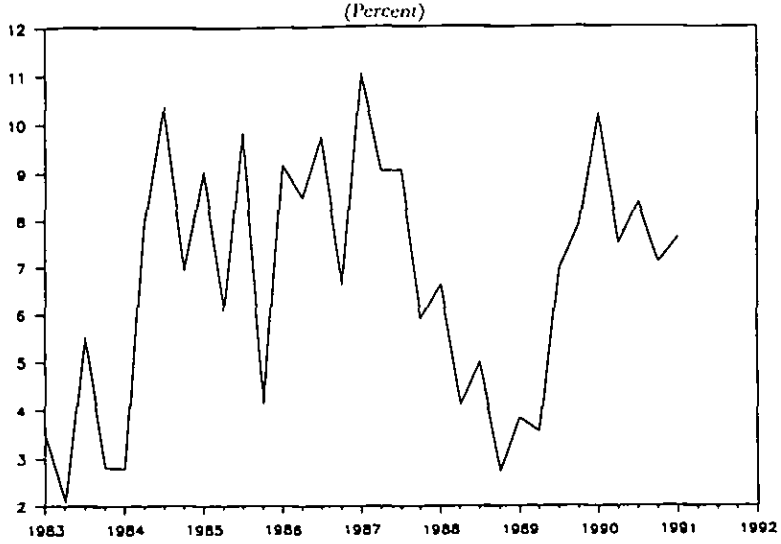
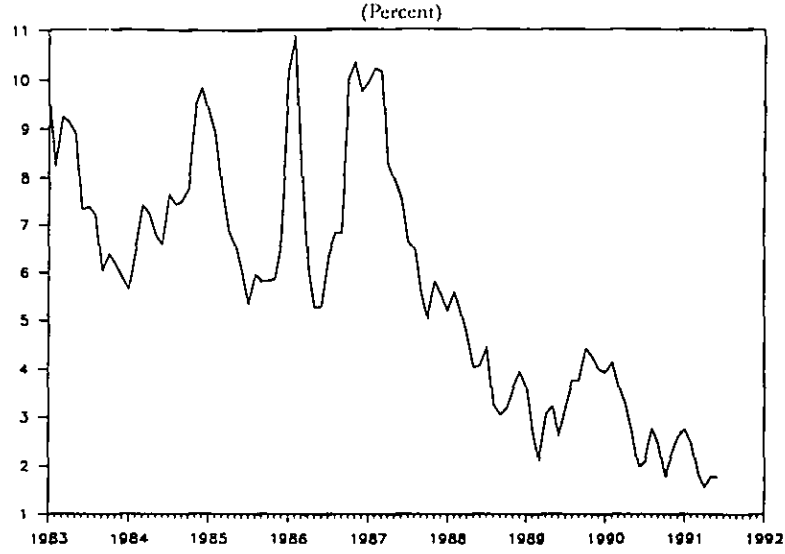


Figure B: IRELAND-GERMANY INTEREST DIFFERENTIAL



gress opens of course the question what else might be done to bring interest rates down further. We return to that point later.

Perhaps most importantly, there has been a striking change in the spirit with which Ireland views itself; there is a distinct optimism and can-do atmosphere. Europe 92 is seen as an opportunity that translates into such investments as the Financial Centre — a totally plausible initiative to take advantage of the combination of moderate wages and professional skills for the growth clerical market which is becoming internationally footloose.

The major questions ahead are three: First, will Europe's slump, caused by German anti-inflation policy, last and will it be protracted enough to sap the current vigour of the Irish economy. Second, if sterling unravels in a major way, can Ireland stock to a DM exchange rate policy? Third, will Eastern Europe offer a formidable competition for Ireland in the area of manufacturing. On this last it may just turn out that Ireland's adjustment was singularly fortunate in timing — just early enough to get ahead of the new competitors.

I turn next to the topic of my Geary Lecture, European money and how to get there. I will also ask what implications a European money might have for the dollar and the United States.

European monetary and financial integration are on our doorsteps.[2] Significant progress has been made in bringing about a convergence of inflation and, beyond the numbers, convergence of stability-oriented economic policy. The question *now is how to carry the progress further. One direction is* institutional: The creation of a common Central Bank and the setting of D-day for the jump to a common money. The other direction for change, and the one explored here, is more pragmatic. It involves the narrowing of exchange margins and introduction of par clearing among the European hard currency countries. That progress need not await the disinflation of Italy or Spain; it can proceed immediately.

The creation of common European monetary institutions is one of the key developments in shaping the world financial system of the 1990s. Is it correct that European money is just the last nail in the coffin of American financial hegemony? A perusal of the key arguments suggests that the fears here are *vastly overrated: the United States does have serious problems,* but the dollar is the least of these, unless the mistake is made to try and create a New Bretton Woods that institutionalizes dollar overvaluation.

Possibilities for a Rapid Transition

A full European financial integration is not easy to achieve. Politically it is attractive, but economically, although divergences have narrowed, they do persist. Monetary integration is often interpreted in terms of the loss of independency of monetary policy and the creation of joint monetary institutions. But in reality there is no longer dependent monetary policy in Europe. The only question is whether exchange rates are or are

2. See European Commission (1990) and Folkerts-Landau and Mathieson (1989).

not fixed which has little to do with monetary policy and is rather a function of wage behaviour and fiscal policy. With capital movement fully liberalized and exchange margins shrinking, monetary policy will have to carry even more of a burden, at even a higher price to public finance.

In most European countries the scope for significant monetary independence has basically vanished. Exchange rate expectations are governed by accumulated imbalances and loss of competitiveness — by political squabbles about who 'makes' inflation and 'who suffers' from it — not by short run monetary policy. Monetary policy only serves to postpone exchange rate crises, but it does so at an important cost to the budget and to economic growth. For most European Monetary System members monetary policy has basically become an instrument for managing the balance of payments and only in the centre country, Germany, is it devoted to setting the EMS inflation trend. Even in economies where there is no crisis in sight there is invariably a concern for realignments in the system, and hence the possibility of any particular country staying with the average rather than with Germany. That in turn requires a level of interest rates that includes a premium for the remote risk of a depreciation.

Once it is recognized that monetary independence is gone and that exchange rate realignments are costly, one can ask why countries would not go ahead and abandon the pretence altogether. In most cases the obstacles cited merely postpone, and without much justification, the necessary adjustments and the move to fixed rates. But that answer does not apply with equal strength to all EC countries. Some like Greece, Portugal or Spain are far out of line with the rest, and should therefore receive separate and differentiated treatment that may stretch over a number of years.

A more rapid implementation of a firmly committed exchange rate policy is likely to be put in place for the core countries. To avoid the fiscal costs associated with exchange and with exchange rate uncertainty, governments in soft currency countries can pressure for increasing exchange rate fixity. They

can immediately discard exchange rate margins altogether. This would signal a much stronger commitments to fixed rates. The strategy is attractive because it is already widely believed in Europe that monetary policy is no longer effective, except to provide financing for the external balance. European monetary policy is made in Frankfurt and any independence is not only an illusion, but is also expensive in terms of domestic debt service. This is so because the option to conduct independent monetary policy will be reflected in higher interest rate.

There is no need at this stage for any joint institutions to manage European money. Central Bank consultation, as it has occurred in the past two or three years, can assure continuing efforts at disinflation. But exchange rate fixity must become more believed and for that purpose governments must take on bigger *actual* commitments. The more governments put at stake, the more credible their policy. The only issue is how to manage the transition. That problem will be just as difficult two, three or five years from now. It is always inconvenient to give up an option. But, because governments retain the option, capital markets retain the risk premium. Recognition of this fact should lead governments to take the radical steps required to move within a short time span — less than a year - to a fully fixed rate.

In this spirit the Netherlands, Denmark, Ireland and France should fix their exchange rates to the DM *without any margin*. In the case of Italy, the occasion should be used for re-denomination to eliminate the excess of zeros from their currency and achieve a simple 1:1 relation. How is such a system implemented? Three institutional arrangements of the payments mechanism help impose the fixed rate. First, economic agents in the core group that adopted zero margins should be allowed to write checks in any of the core group currencies. Second, banks in the core group countries must clear all checks at par, independent of origin or denomination.[3] Third, Central Banks should organize a core-

3. The provision of par clearing was an essential innovation associated with the Federal Reserve system. The existence of a common currency area, prior to the creation of the federal Reserve, was not enough to establish fixed rates between various cities.

group clearing system. These three arrangements would assure that rates are in fact fixed at par. The only departure would stem from a crisis in confidence.

Once a pragmatic fixed rate system has operated for a while, the transition to an institutionalized monetary system would be far easier than it appears today. The purpose of describing the transition process has been to highlight that this is where the problems are, not in the design of the institutions that ultimately protect the stability of money.

We next raise three questions about the suggested move to eliminate margins: First, what is involved in the sacrifice of monetary sovereignty? Second, are exchange rate margins useful? Third, is it enough to eliminate margins in order to implement integration of the payments mechanism?

The Illusion of Monetary Sovereignty

During the 1980s, high inflation countries in Europe did their best to push their inflation rates down to German levels. France and Ireland, for example, fully succeeded. The success at disinflation is very largely due to the acceptance of tight monetary and fiscal policy. These were invariably supplemented by incomes policy in the form of an EMS exchange rate arrangement and wage agreements. Acceptance of German-style monetarism was a *sine qua non* of the disinflation strategy: monetary policy was there to defend the exchange rate and realignments at best could compensate partially for loss of competitiveness.

Table 2: *Inflation Performance*[a]

	1982	*1989*	*1991*[b]
France	11.5	3.4	3.3
Germany	5.3	3.0	3.1
Ireland	14.9	3.9	3.0
Italy	16.9	6.3	6.4
The Netherlands	5.3	2.1	2.7

[a]Consumption deflator. [b]Forecast.
Source: OECD.

The question now arises whether moving to fixed-fixed rates involves a significant, or indeed, any loss of monetary sovereignty. And if such a loss is involved, how should one judge the trade-off. To determine this one must realize monetary sovereignty has three dimensions: the leeway to change the exchange rate; the revenue from money creation; and the ability to set short term interest rates. Monetary integration has a bearing on each of these three.

Consider first the ability to change the exchange rate. The great effort of the 1980s *not* to move exchange rates, even when employment considerations made a gain in competitiveness very tempting, does suggest that the exchange rate has lost much of its attraction as a stabilization tool. Real wages are sticky downward and devaluation is no longer an attractive way to try and resolve cyclical or even structural problems. Any devaluation, without incomes policy, translates quickly into inflationary pressure and immediately into higher interest rates in anticipation of a wage-exchange rate cycle. Since it is not clear whether a lasting real wage cut can be brought about. Given that uncertainty, the inflation cost and the cost arising from the loss in credibility in assets' markets, devaluation is a very precarious policy instrument among EMS partners.

A further consideration is this: If one country devalues, what would prevent a situation of competitive devaluation. If France devalues, why would Italy and Britain not follow? This is all the more the case if a devaluation is the response to an external shock rather than the remedy for a cumulative and ultimately stifling loss of competitiveness. Since major shocks often tend to be common shocks rather than country specific ones, the hypothesis of successful competitive depreciation must be ruled out not only on economic grounds but also on the grounds of European polity.[4]

4. Of course, the exception proves the case. Germany's unification shock is country-specific and thus might make the case for exchange rate action. Interestingly, Germany refused and few of its partners urged her on to have a sizeable appreciation. All wanted more competitiveness, none would accept more inflation.

The second issue is seigniorage. The gains from money creation are substantial in countries where inflation is moderately high — say 20 per cent per year — and financial institutions are primitive. That is no longer the case for industrial countries and where it is, the eagerness to get out of the inflation trap seems well worth the loss of seigniorage. For countries with moderate inflation there need be no net loss in seigniorage, at least to a first approximation. The common European money (or the national moneys on a rigidly fixed exchange rate) will still be issued and hence the proceeds from money creation are there just as they were before. The sharing of these gains or their earmarking for common purposes is simply a fiscal issue.

Finally there is narrow monetary sovereignty in the form of practising domestic interest rates different from this abroad. The room for interest rate policy has virtually disappeared: Mitterand's attempt a decade ago is well remembered and since then nobody has tried in the monetary area the line 'Damn the torpedoes, full steam ahead.' France has monetary sovereignty in the sense of being able to cut its interest rates, but the sovereignty comes at the price of an exchange rate crisis and a collapse of the franc and the sharp resurgence of inflation. Monetary sovereignty is gone the moment there is exchange rate targets and controls have disappeared. The 1980s are a monument to the conscious, public, determined abandonment of monetary sovereignty. The decline in French inflation, and interest rates, is the market's reward for demonstrating that the country is no longer willing to exercise the monetary sovereignty option.

It may well be argued that a country like France will have *more* influence on its own interest rates in the exercise of *joint* monetary policy than in the current state of affairs where the country acts like a fellow, on watch and on probation.

Are there any Merits to Exchange Margins?

Exchange rate margins are a legacy of the gold standard. They have slipped into modern exchange rate arrangements seemingly without much discussion. Certainly the question of what is the *optimal* exchange rate margin is rarely asked and even less frequently answered.[5] Only in the very recent discussion of target zones does the issue of margins make an appearance at all and here mostly in terms of their stabilizing characteristics rather than as an optimizing problem in currency management. In practice, of course, the margins and the credibility of the intervention commitment and capacity do play a role in setting interest rate differentials.

Historically, exchange rate margins emerged from the operation of the international gold standard. If the Bank of England bought gold at x pounds per ounce and the Bank of France sold gold at y francs per ounce then the exchange rate of francs per pound would be y/x. In fact the Bank of England practised a small spread of 1.5 pence between buying and selling prices and so did the Bank of France. As a result, some fluctuations around par already become possible as a consequence of these spreads. Further room for margins came from the cost of shipping gold which included the actual shipping and handling cost, insurance, and interest lost while gold was in transit.

The operation of Central Banks and arbitrageurs under a commodity standard, gave rise to modest margins within which the exchange rate for drafts could depart from par before it would become profitable to engage in actual gold shipments rather than shipping claims. Specifically there were two ways to make a remittance to France: buying a draft on Paris at the current exchange rate or buying gold from the Bank of England, shipping it to France, redeeming it for Francs at the Banque de France, and using the proceeds to effect payment. The buy and sell spreads of the Central Banks together with interest and transport costs would define the maximum spread of exchange rates relative to par.

5. See, however, Mundell (1964) and Argy and Porter 1972).

Exchange rate margins slipped into the fiat standard of the postwar period apparently without much discussion. Monetary authorities undertook to buy and sell their currencies in exchange for dollars with a maximum spread of one per cent around the declared par. With foreign exchange taking the form of credit balances in foreign banks, further spreads due to transport cost interest and insurance disappeared. Following the period of flexible rates, in the emerging European Monetary System, margins reappeared as 'limited flexibility'. Narrow margins of two per cent and the wider margins for countries like Italy, Spain, or the UK whose inflation performance was far off-course.

In the building up of the European Monetary System two kinds of exchange rate commitments were undertaken. Some countries, for example Italy, accepted a six per cent margin; others, including Ireland undertook a much tighter commitment. For given inflation differentials the wider margin would, of course, accommodate a longer period of inflation differential before new realignment would become necessary. On the other hand, the wider margin also made it more apparent that accommodation was part of the strategy. The narrow margin, by contrast, signalled the possibility of a tighter commitment to fixed rates and a far lower willingness to accommodate. Not surprisingly, independent of initial conditions, the countries with wide margins still have the high rates of inflation. Countries with low margins have cut their inflation rates to German levels or below.

The interest in margins may come also in a non-inflationary context. Exchange rate movements within fairly wide margins offer the possibility of real exchange rate changes and international interest differentials, both of which could be used as stabilizing devices in a cyclical context. This argument is often made in Scandinavia.[6] Suppose a country experiences a boom. Exchange appreciation within wide margins will help directly control inflation via the effect on import prices. It will

6. See Korkman (1990, 1991).

also help because real appreciation reduces competitiveness in the traded goods sector and hence slows the growth in demand for domestic goods. Finally, when the exchange rate is high, then the likely course for growth is down. Hence high domestic nominal interest rates are appropriate from the point of view of international uncovered interest arbitrage. These high rates in turn will be high *real* rates. The wider the margin, the greater the scope for depreciation as seen from the top and hence the wider the interest differential that can be practised before monetary policy is defeated by capital flows.

Without margins, the scope for anticyclical monetary policy and for the stabilizing effects of real exchange rates would be lost. This argument is altogether persuasive. But it must be recognized that the story only becomes interesting if there is really scope for movement. Very small margins have the inconvenience of potentially variable exchange rates without the significant pay-off. For larger margins, the scope for policy effectiveness increases, but the integrating effects of fixed rates are sacrificed.

Once it is accepted that exchange rate margins should be small, as it is for most EMS members today, there is no reason not to go all the way and abolish margins altogether. Imagine then for a moment a situation where Germany and France agreed to abolish margins altogether. With the slightest departure from par — measured in fractions of a fraction — Central Banks would have to meet the excess demand or supply of foreign exchange.

To understand the mechanism, consider for a moment the Federal Reserve System. As part of the operation of the System, the Fed offers member banks the privilege of the wire-using free of charge: moneys can be transferred on the books of the Fed from one bank to another. With zero margins, Central Banks would offer the same service but with the additional feature of accepting instructions to transfer on demand either local currency or foreign currency at a fixed rate. The private market, because of the availability of foreign exchange at par from the Central Banks would therefore perform the arbitrage

function. If Central Banks in the wholesale market buy and sell without margins, rates would not depart from par except for transactions' costs. At the wholesale level margins would be virtually zero, at the retail level there might be a minor spread.

The counterpart of zero exchange rate margins is, of course, full equalization of interest rates.[7] With the gradual disappearance of devaluation as common policy action, interest rate differentials have narrowed sharply. For example, in the case of Belgium, as Table 3 shows, differentials for short-terms assets had fallen to as little as half a percentage point by mid-1991.

Table 3: *Belgium-Germany Differential*
(Per cent per year, Treasury Bills)

1988	*1989*	*1990*	*1991*[a]
3.0	2.2	1.5	0.5

[a]mid-91
Source: IMF.

A world of strictly fixed exchange rates would, of course, require that monetary policy of the co-operating Central Banks be strictly *joint*. That may either mean that it is *jointly* exercised or else that there be a well-defined pattern of leader and followers. But that is just as much the case these past few years when there has been limited margins. France today does not have the room for a significant exercise of monetary independence. What would be lost in the transition to zero margins except perhaps the illusion of monetary sovereignty? However, gains could be made because zero margins create a far deeper integration of markets. This is certainly the case if they are combined, as we examine below, with par clearing for cross border payments.

7. A proviso must be made here to reserve the possibility of a realignment as long as there is no unique currency. This is known as the 'peso problem' — an event not observed (such as a peso devaluation between 1954 and 1976) but not impossible — and hence reflected in a forward discount and a modest interest differential.

Par Clearing

When the Federal Reserve System was created one of the very controversial issues was the introduction of par clearing: member banks are required to collect checks drawn on other banks *at par,* without charge or fee.[8] Thus a $100 cheque on a California bank deposits in a Boston bank will be credited at $100. The obligation to clear cheques at par robbed banks of a great line of business - charging handsome fees for clearing out-of-town cheques. Exchange rates between various centres were flexible; they depended on supply and demand. Thus, for example, drafts in Boston on New Orleans or Chicago would trade at a price reflecting demand and supply (including seasonals!). The only limit on rates was set by the possibility of shipping the claims physically, collecting them in the other location, and shipping back the proceeds. The exchange margins narrowed with the progress of transport, but they remained until par clearing was imposed.[9]

In Europe today the payments mechanism across borders is extremely underdeveloped. The progress on common money has not at all been accompanied by a serious discussion of a payments mechanism that would assure fixed rates. Thus introduction of par clearing for cross border transactions seems an important agenda item both to make the monetary integration complete but also to enhance the Europe 1992 internal market objectives. Only when a cheque can be put in the mail payable at face value will there be significant market integration at the intermediate level. The situation today is a far cry from par clearing since charges are as high as six per cent and the delay for clearing cheques is long and random. As a result of the fees and complications involved in cross-border payments, the effective exchange rate margins for retail level transactions are of course far larger than the official limits.

8. See Harding (1925) and Garbade and Silber (1979).
9. It is interesting to note that as long as the Ireland/UK rate was fixed there was par clearing between the two countries. With the transition to a floating rate par clearing vanished.

We next turn to the international consequences of increasing European monetary integration. The key question here is what the development of an integrated European market means for the dollar and for the United States in international finance.

Europe's Money and the Future of the Dollar

The decline in the US net international creditor status, the sharp loss in international competitiveness, the relative decline of US financial institutions, both in terms of size and stability, all mark a watershed for the dollar as the dominant asset in world finance. Monetary and financial integration underway in Europe point clearly to a new world financial scene where a European asset will emerge that is at least rival to the dollar, if not dominant. Integration in Europe promotes this new asset by a three-pronged approach: the creation of an integrated financial area, monetary integration, and the creation of a Europe-wide payments mechanism.

If European integration gives rise to a well-regulated and inflation-stable asset, and if US financial performance continues to deteriorate, then there will be clear problems for the dollar and these difficulties will exacerbate the difficulties of adjustment in the US economy in the 1990s.

European integration in the area of money, finance, and the payments mechanism is far from accomplished. The details are not even decided and the question of the accompanying political integration remains unresolved and controversial. But even so, pragmatic progress in the direction of integration has been underway for a decade and is irreversible. The attraction of this area of financial stability for the periphery is clearly indicated by the recent decisions in Finland, Sweden, and Austria to adopt EMS-pegged exchange rate regimes. With the growth in intra-European trade, finance, and policies, the central roles of the dollar in world finance is being eroded.

If this prediction is correct, a number of questions emerge. First, what are the costs to the United States of losing monetary

hegemony. The conclusion here is that the costs are unlikely to be important. The chief reasons are two: US institutions do not have an exclusive franchise on doing dollar-denominated business and US dollar-denominated liabilities today are interest bearing so that the gains from their issues are insignificant. In other words, nobody is doing us a favour by holding our debts.

The second question is: What special policies does the United States need to cushion the fall from supremacy? Specifically, should the United States try and forestall the course of events by a major international currency proposal? The answer here is emphatically no. We should stay with a flexible exchange rate and avoid landing up with an overvalued currency as a result of a misled emphasis on having a hard currency.

Dollar Dominance

The predominant position of the dollar in world finance is represented by its use as a 'vehicle currency'.[10] Trade is invoiced in dollars, world trade is financed with dollar credits, dollar balances are held by corporations world wide, and dollar instruments are held by official agencies, banks abroad, and by institutional and individual investors. Cross-border lending, sovereign and private is dollar-denominated. Dollar cash serves as stable money throughout Latin America, in Poland, in Asia, and in underground markets worldwide.

It is clear that none of these functions is performed *exclusively* by the dollar. Some trade is invoiced in yen or in DM or even in sterling. Credits for trade financing or cross-border lending do also take the form of DM or yen loans. But even today, after dollar weakness and nearly 20 years of floating exchange rates and an increasing net debtor status for the United States, the dollar predominance remains. In part it is merely a reflection of the relative size of the US economy. The US is by far the largest economy in the world.

10. On the concept of vehicle currencies see Swoboda (1968).

Table 4: *Economic Size*
(Share of World GNP)

Industrial Countries		*Developing Countries*	
Europe	29.6	Africa	2.2
Japan	15.3	Asia	7.2
United States	27.1	Europe	6.0
Canada	2.7	M. East	2.6
		L. America	5.7
		E. Europe	1.6
		USSR	4.0

Source: IMF *World Economic Outlook.*

No other financial market has the sheer size, the variety of instruments, the degree of competition, and the international openness. Hence the predominance. Moreover, the US capital market is wide open to cross border transactions without control or red tape; exchange controls have never existed in this century; clear legal processes apply in a US jurisdiction; taxation of capital income for non-residents is modest if not absent altogether; competition and efficiency make for low transactions' costs. The closest rival, Japan, cannot offer these advantages.[11] There is not only the much smaller size but also clannish restrictions on competition especially by foreigners, exchange control until very recently, and uncertainty about Japan's long-term role in relation to the Western world. These factors stand in the way of the confidence required for a major international role of the yen. That is not to say that Japan does not have deep pockets, but it does limit the role of Japan's capital market and the yen as an international asset.

Europe's Competition

The developments in Europe open up genuine possibilities for a competitor to the dollar. Over the past decade Europe has evolved into a hard currency region, centred on the Deutsche

11. See, however, Tavlas and Ozeki (1991).

Mark. The initial commitment was mostly a device for Germany to avoid sharp appreciation relative to its chief trading partners. For the weaker currencies the EMS was a means to cut inflation by a tough stance on exchange rates.

Realignments in the EMS have become increasingly infrequent and membership, formal or informal, has been spreading. Until 1986 there were basically annual realignments involving most currencies. Since then there have only been three realignments and none in the past 18 months. Thus exchange rates have become far firmer.

A further development leading to the use of a European currency as a vehicle currency has been the narrowing of margins in the EMS. Countries which had no specific margins like Spain adopted commitments, countries like Italy that had wide margins have narrowed them, and ambitious countries like Belgium have narrowed their margins to less than one per cent. Countries outside the community, notably Scandinavia and Austria, have started pegging their currencies to the EMS. The fact then is that Europe has become a centre of gravity and that the stable DM-Franc relation is the centre of that emerging block.

Against the background, further institutional integration is now being planned. This integration falls into three areas.

— *The Creation of a Common European Money Managed by a European Central Bank.* So far there is only a system of fixed exchange rates. But the transition to the more ambitious scheme is already quite far advanced. The blueprint for a Central Bank is ready and the intergovernmental conference to change the EC Treaty is scheduled. The chief question concerns the exact timing, or the exact preconditions, for the move from the current informal fixed rate system to a single money.

— *A Better Payments' Mechanism.* Having a single money does not in and of itself deliver an efficient payments mechanism. The payments' mechanism is still cumbersome if not primitive and as such an obstacle to trade. But par clearing is certainly going to be a by-product of common money and it may even

come before, as an aspect of the internal market. Once par clearing takes place, European money becomes a highly useful money.

— *Under the Heading of the "Internal Market" Programme Cross Border Liberalisation of Financial Services is Taking Place.* It is expected that increased competition will reduce dramatically the transactions' costs for all kinds of financial transactions from insurance and underwriting to interest costs on consumer loans. Among the efficiency gains to be derived from the internal market, the improvement in financial efficiency counts for two-thirds of the benefits.

With financial integration inevitably will come the creation of new financial assets that exploit the large scale of the new European capital market. The creation of a European commercial paper market and a broad market for public debt will not take long. Because of the economic size of the market, and the competition allowed and encouraged, the assets are bound to be rivals to dollar denominated securities. And markets that emerge will be important competitors to US located financial markets.

Costs to the US

What are the costs to the United States of competition from a European money and an efficient financial market?[12] The costs are threefold.

The world demand for US currency and bank balance held in dollars will decline, at least relative to a trend without these European developments. That implies a fall in the demand for the US monetary base and hence a loss of seigniorage revenue.

The creation of a usable European money will divert demand away from dollars as the universal second (or first) hand-to-hand currency. Of course, in Latin America, the dollar will still serve that function, but presumably much less in Asia or in

12. For an earlier exploration of this question see Krause and Salant (1973).

Europe itself. Also as a store of value, for households in politically or economically unstable countries or for the underground, dollar balances now have competition.

It is very difficult to know just how much US currency is held today abroad. It is even more difficult to know how much of a diversion toward the EMU might be expected. In the 1980s the revenue from seigniorage was on average 0.37 per cent of GNP for the monetary base and 0.32 per cent of GNP for currency. Thus one is not talking of really big numbers. As a guess, with the development of an EMU the seigniorage revenue might fall by 0.1 per cent.

There is the additional question of a once and for all shift out of US currency into the ECU. For better or worse, such substitution never occurs from one day to the next but rather follows a *logistic curve*. Thus an overnight collapse of demand for US high powered money is unlikely. In any event, total currency outstanding is only $250 billion. Suppose that one-third of that demand might be affected by currency substitution toward the EMU and that it were to decline by 50 per cent, that still only represents a fall in demand of $31 billion. In terms of asset market shocks that is a rather small magnitude. Table 5 shows the US net external position to put the numbers in perspective.

There has traditionally been a concern with the possibility of dollar overhang, especially with respect to foreign official holdings of dollar assets. The right view to take here is that the difference between corporate treasureres and the managers of

Table 5: *US Net Foreign Investment Position (Billion $)*

	1980	*1990*
Net US position	333	−412
US assets abroad	922	1,764
Direct investment	385	598
Foreign assets in the US	542	2,176
Official assets	176	370
Direct investment	124	466

foreign official reserve holdings has become minor. Both are out to make profits and weigh interest differentials against capital gains or losses from exchange rate movements.

There is no overhang. Today interest rates are just high enough to make official and private investors hold the outstanding stock of dollar securities. But these positions are by no means frozen. Safe haven considerations might overnight lead to a massive shift in dollar assets. By contrast, loss of confidence in US monetary management could bring about a flight out of US assets in no time. There is no special concern for foreign official holdings of dollar assets if only because today they represent a small share of US external liabilities.

The second area where a US loss might occur is in relation to the risk premium charged on dollar denominated assets. Portfolio holders for securities of which there is a larger quantity outstanding than belongs into a maximally diversified portfolio. If the creation of a European money creates an asset that reduces the demand for dollars then an increased premium will be charged for holding dollar assets. The financial area where the dollar is the natural currency will therefore experience an increase in the cost of capital. To some extent this can be avoided by issuing EMU denominated claims, but that will not be convenient for everybody. Hence, there will be some loss, just how much is hard to know. Models based on portfolio diversification suggest a fraction of a per cent. In the aggregate that represents a substantial transfer away from the issuers of dollar denominated claims.

The reduced cost of capital has implications for banks that operate substantially in the EMU mode. Their privileged access to capital allows them to compete more effectively for good loans. The resulting improvement in their portfolios feeds back favourably to improve yet further their cost of capital. US financial institutions whose habitat is the dollar will, as a result, experience a deterioration in their capital market position.

The reduced capital costs and the reduced costs of all financial services and transactions increase the competitiveness of European firms relative to those in the US. Working in a

more efficient financial system, and possibly in a more stable one, simply means higher competitiveness.

The third area where losses will occur is in financial services. To the extent that financial industries in the US have a privileged franchise for dollar business, the creation of rival assets and rival centres will cause a loss. The size of this loss is difficult to judge. In the first place, US financial firms will actively participate in the European and world wide-business. But, even so, financial liberalization works primarily to increase the scope of European-located institutions.

The fourth area involves a change in the role of the US as a provider of stable money. It is one thing to have a rival, it is another if that rival produces a superior money. It is quite possible that in the 1990s there will be a European money *and* that this money will act like the DM and hence be far better than the dollar. This currency could lead, once and for all, to a shift away from the dollar with all the ramifications which a shift entails.

A positive effect of the rise of European money is the fact that it provides Eastern Europe with a plausible alternative to their own money.[13] Use of Western European currency may allow the Eastern Europeans to avoid Latin American style hyper-inflation and the accompanying social and economic problems.

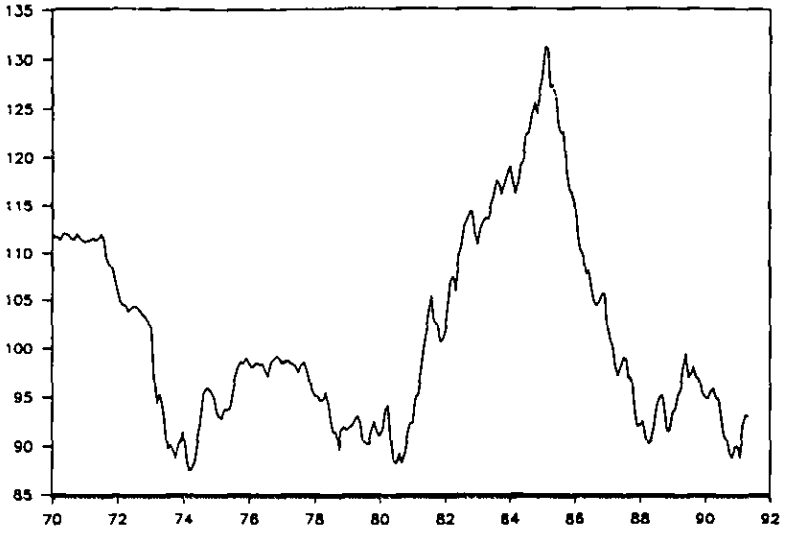
A New Bretton Woods?

For the US the chief question is what exchange rate policy to adopt in the face of these European developments. There are two choices. One is to move aggressively for a system of fixed exchange rates, on a parallel track with the European monetary unifications, the other is to maintain flexibility of rates as an important cushion.

In the fixed rate option, as Europe is moving closer together, but the US is not allowing the North Atlantic gap to widen but rather urges a narrowing in the style of Bretton Woods. This

13. See on this issue Association for European Monetary Union of Europe (1991).

Figure C: US: THE REAL EXCHANGE RATE
(Index 1980-82 = 100)



would require co-ordination of monetary policy between the European Central Bank and the US. All the dilemmas of the 1960s would re-emerge, more so if the US has problems with growth and gets caught between the objectives of competitiveness and price stability. The greatest risk is that the fixing exchange rates locks the US into a level of competitiveness that is incompatible with growth. That risk is more possible once budget cutting gets underway. Today's level of the dollar is far from competitive as an engine of growth (see Figure C).

The alternative is managed flexible rates. The managed part would involve accommodating shifts in the demand for *money* by co-ordinated, sterilized intervention. This is precisely the kind of sterilization required when current substitution is the issue. Beyond that accommodation of money demand shifts, exchange rate policy should be such as to sustain full employment. That means a substantially improved budget, low real interest rates, and a cheap dollar. It would be a serious mistake to make the dollar extra hard at the expense of full employment. Such a policy would not last and would merely imply

even higher interest rates and worsening problems of financial institutions.

The strengthening of Europe's money is moderately bad news for the United States. The spill-over effects to the US in terms of direct losses in seigniorage or in business opportunities are present but not dramatic. However, there are larger costs. These come from the appearance, in world business and politics, of a dynamic Europe in contrast to a staggering United States. The European developments therefore make finding a cure to our basic problems - deficits, education, productivity, financial stability - even more important. This cure is best done by attacking the basics, not by opting for a hard exchange rate.

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